

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following is a discussion and analysis of the State of Michigan's (the State's) financial performance, providing an overview of the activities for the fiscal year ended September 30, 2004. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section.

HIGHLIGHTS

Government-wide:

- At September 30, 2004, the State's assets exceeded its liabilities by \$17.2 billion.
- The State's unrestricted net assets were (\$954.8) million as of the close of the year. A positive balance in unrestricted net assets represents excess assets available to meet ongoing obligations. A negative balance means that it would be necessary to convert restricted assets to unrestricted assets if all ongoing obligations were immediately due and payable.
- The State's total net assets decreased by \$1.0 billion (5.7 percent) during fiscal year 2003-2004.

Fund Level:

- As of the close of the fiscal year, the State's governmental funds reported combined ending fund balances of \$3.3 billion. Of this amount, \$495.5 million is *unreserved fund balance* and, therefore, available to fund general-purpose expenditures of the respective funds in future years. The remaining \$2.8 billion is reserved for specific purposes, such as education and transportation.
- The State's three major governmental funds, the General Fund, Counter-Cyclical Budget and Economic Stabilization Fund, and the School Aid Fund, all closed the fiscal year with positive fund balances, totaling a combined \$1.3 billion. In the General Fund and School Aid Fund, the entire fund balance, \$1.2 billion and \$74.1 million, respectively, is reserved for specific purposes. In the Counter-Cyclical Budget and Economic Stabilization Fund, the entire fund balance of \$81.3 million is unreserved.
- The State's proprietary funds reported net assets at year-end of \$1.3 billion. This represents a decrease of \$602.8 million (31.8 percent) compared to the prior year-end.

Long-term Debt:

- The State's total long-term debt (bonds and notes payable) as of September 30, 2004 was \$6.2 billion. This is an increase of \$255.1 million since the last fiscal year-end. The increase represents the net difference between new issuances, payments, and refundings of outstanding debt.

More detailed information regarding the government-wide, fund level, and long-term debt activities can be found beginning on page 7.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains other supplementary information in addition to the basic financial statements.

Government-wide Statements (Reporting the State as a Whole)

The Statement of Net Assets and the Statement of Activities are two financial statements that report information about the State, as a whole, and about its activities that should help answer this question: How has the State's financial position, as a whole, changed as a result of this year's activities? These statements include all non-fiduciary assets and liabilities using the accrual basis of accounting. The current year's revenues and expenses are taken into account regardless of when cash is received or paid.

The Statement of Net Assets (pages 14 and 15) presents all of the State's assets and liabilities, with the difference between the two reported as *net assets*. Over time, increases and decreases in net assets measure whether the State's financial position is improving or not.

The Statement of Activities (pages 16 and 17) presents information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods (e.g. uncollected taxes and earned but unused vacation leave).

Both statements report three activities:

- *Governmental Activities* – Most of the State's basic services are reported under this category. Taxes and intergovernmental revenues generally fund these services. The Legislature, the Judiciary, and the general operations of the Executive departments fall within the governmental activities.
- *Business-type Activities* – The State charges fees to customers to help it cover all or most of the cost of certain services it provides. Lottery tickets, liquor purchases, and the State's unemployment compensation services are examples of business-type activities.
- *Discretely Presented Component Units* – Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. The State has 14 authorities and 10 universities that are reported as discretely presented component units of the State.

This report includes two schedules (pages 21 and 23) that reconcile the amounts reported on the governmental fund financial statements (modified accrual accounting) with governmental activities (accrual accounting) on the appropriate government-wide statements. The following summarizes the impact of transitioning from modified accrual to accrual accounting:

- Capital assets used in governmental activities are not reported on governmental fund statements.
- Certain tax revenues that are earned, but not available, are reported as governmental activities, but are reported as deferred revenue on the governmental fund statements.
- Other long-term assets that are not available to pay for current period expenditures are deferred in governmental fund statements, but not deferred on the government-wide statements.
- Internal service funds are reported as governmental activities, but reported as proprietary funds in the fund financial statements.
- Certain pension trust funds have been funded in excess of their annual required contribution. These assets are recorded only in the government-wide statements.
- Deferred issue costs are capitalized and amortized as governmental activities, but reported as expenditures in the governmental fund statements.
- Unless due and payable, long-term liabilities, such as capital lease obligations, compensated absences, litigation, bonds and notes payable, and others only appear as liabilities in the government-wide statements.
- Capital outlay spending results in capital assets on the government-wide statements, but are reported as expenditures on the governmental fund statements.
- Bond and note proceeds result in liabilities on the government-wide statements, but are recorded as other financing sources on the governmental fund statements.
- Certain other outflows represent either increases or decreases in liabilities on the government-wide statements, but are reported as expenditures on the governmental fund statements.

The Notes to the Basic Financial Statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes can be found beginning on page 41 of this report.

Fund Financial Statements (Reporting the State's Major Funds)

The fund financial statements begin on page 20 and provide detailed information about the major individual funds. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the State uses to keep track of specific sources of funding and spending for a particular purpose. In addition to the major funds, page 96 begins the individual fund data for the non-major funds. The State's funds are divided into three categories – governmental, proprietary, and fiduciary – and use different accounting approaches.

- *Governmental funds* -- Most of the State's basic services are reported in the governmental funds, which focus on how money flows into and out of those funds and the balances left at year-end that are available for future spending. The governmental fund financial statements provide a detailed short-term view of the State's general government operations and the basic services it provides. Governmental fund information helps determine whether there are more or fewer financial

resources that can be spent in the near future to finance the State's programs. These funds are reported using *modified accrual* accounting, which measures cash and all other financial assets that can readily be converted to cash. Governmental funds include the General Fund and special revenue, capital project, debt service, and permanent funds.

- **Proprietary funds** -- When the State charges customers for the services it provides, whether to outside customers or to other agencies within the State, these services are generally reported in proprietary funds. Proprietary funds (enterprise and internal service) utilize accrual accounting, the same method used by private sector businesses. Enterprise funds report activities that provide supplies and services to the general public. An example is the State Lottery Fund. Internal service funds report activities that provide supplies and services for the State's other programs and activities - such as the State's Vehicle and Travel Services. Internal service funds are reported as governmental activities on the government-wide statements.
- **Fiduciary funds** -- The State acts as a trustee or fiduciary for its employee pension plans. It is also responsible for other assets that, because of a trust arrangement, can be used only for the trust beneficiaries. The State's fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets beginning on page 32. These funds, which include pension (and other employee benefit), private-purpose, and agency funds, are reported using accrual accounting. The government-wide statements exclude fiduciary fund activities and balances because these assets are restricted in purpose and do not represent discretionary assets of the State to finance its operations.

Additional Required Supplementary Information

Following the basic financial statements is additional Required Supplementary Information that further explains and supports the information in the financial statements. The Required Supplementary Information includes budgetary comparison schedules reconciling the statutory and generally accepted accounting principles (GAAP) fund balances at fiscal year-end, and condition and maintenance data regarding certain portions of the State's infrastructure.

Other Supplementary Information

Other supplementary information includes combining financial statements for non-major governmental, proprietary, and fiduciary funds, and non-major discretely presented component units. These funds are added together, by fund type, and presented in single columns in the basic financial statements, but are not reported individually, as with major funds, on the governmental fund financial statements.

FINANCIAL ANALYSIS OF THE GOVERNMENT AS A WHOLE

The State's combined net assets decreased \$1.0 billion (5.7 percent) over the course of this fiscal year's operations. The net assets of the governmental activities decreased \$437.7 million (2.7 percent) and business-type activities had a decrease of \$600.5 million (or 33.9 percent).

Changes in Net Assets For Fiscal Year Ending September 30 (In Millions)						
	Governmental Activities		Business-type Activities		Total Primary Government	
	2004	2003 *	2004	2003 *	2004	2003*
Current and other non-current assets	\$ 9,601.8	\$ 9,368.1	\$2,189.2	\$2,860.3	\$11,791.0	\$12,228.4
Capital assets	18,694.8	18,669.0	.6	.6	18,695.4	18,669.6
Total assets	<u>28,296.6</u>	<u>28,037.1</u>	<u>2,189.8</u>	<u>2,860.9</u>	<u>30,486.4</u>	<u>30,898.0</u>
Current liabilities	4,359.5	4,042.1	543.2	551.9	4,902.7	4,594.0
Long-term liabilities	7,941.5	7,561.8	475.6	537.4	8,417.1	8,099.1
Total liabilities	<u>12,301.1</u>	<u>11,603.9</u>	<u>1,018.8</u>	<u>1,089.3</u>	<u>13,319.9</u>	<u>12,693.2</u>
Net assets:						
Invested in capital assets, net of related debt	14,962.9	14,996.9	.6	.6	14,963.5	14,997.5
Restricted	1,993.3	1,886.3	1,164.5	1,765.7	3,157.9	3,652.0
Unrestricted	(960.7)	(450.0)	5.9	5.3	(954.8)	(444.7)
Total net assets	<u>\$15,995.6</u>	<u>\$16,433.3</u>	<u>\$1,171.0</u>	<u>\$1,771.5</u>	<u>\$17,166.6</u>	<u>\$18,204.8</u>

* The prior year columns have been restated to reflect the implementation of GASB Technical Bulletin 2004-1 and the addition of the Attorney Discipline System.

Michigan

- The largest component, \$15.0 billion, of the State's net assets reflects its investment in capital assets (e.g. land, buildings, equipment, infrastructure, and others), less any related debt outstanding that was needed to acquire or construct the assets. Restricted net assets are the next largest component, comprising \$3.2 billion. These represent resources that are subject to external restrictions, constitutional provisions, or enabling legislation on how they can be used. The State's unrestricted net assets were (\$954.8) million as of the close of the year. A positive balance in unrestricted net assets represents excess assets available to meet ongoing obligations. A negative balance means that it would be necessary to convert restricted assets to unrestricted assets if all ongoing obligations were immediately due and payable.

The following condensed financial information was derived from the government-wide Statement of Activities and reflects how the State's net assets changed during the fiscal year:

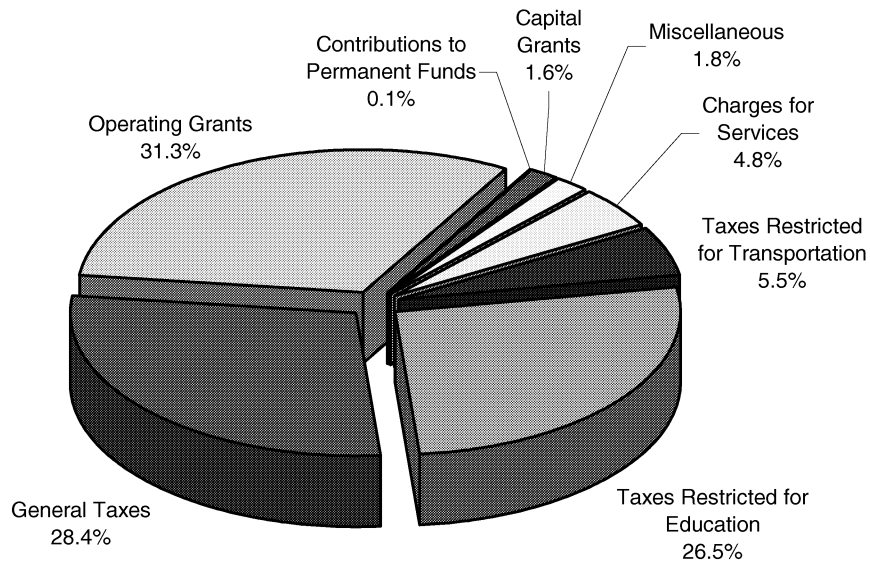
Changes in Net Assets For Fiscal Year Ending September 30 (In Millions)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2004	2003	2004	2003	2004	2003
Revenues						
Program revenues						
Charges for services	\$ 1,801.4	\$ 1,782.9	\$4,500.6	\$4,039.8	\$6,302.0	\$5,822.7
Operating grants	11,783.5	11,290.7	76.8	135.1	11,860.2	11,425.8
Capital grants	618.4	546.7	-	-	618.4	546.7
General revenues						
General taxes	10,672.9	10,133.7	12.0	11.3	10,684.9	10,145.0
Taxes restricted for educational purposes	9,958.3	10,098.3	-	-	9,958.3	10,098.3
Taxes restricted for transportation purposes	2,077.0	2,021.1	-	-	2,077.0	2,021.1
Unrestricted investment and interest earnings	9.7	14.1	1.2	1.1	11.0	15.2
Miscellaneous	677.8	813.6	-	-	677.8	813.6
Total revenues	37,599.1	36,701.1	4,590.6	4,187.4	42,189.7	40,888.5
Expenses						
General government	1,748.6	1,714.8	-	-	1,748.6	1,714.8
Education	14,418.9	14,840.0	-	-	14,418.9	14,840.0
Family independence services	3,985.9	3,891.7	-	-	3,985.9	3,891.7
Public safety and corrections	2,256.4	2,159.5	-	-	2,256.4	2,159.5
Conservation, environment, recreation, and agriculture	674.4	612.6	-	-	674.4	612.6
Labor, commerce, and regulatory	920.1	901.6	-	-	920.1	901.6
Health services	9,605.2	9,362.9	-	-	9,605.2	9,362.9
Transportation	3,104.8	2,792.8	-	-	3,104.8	2,792.8
Tax expenditures	702.7	707.8	-	-	702.7	707.8
Intergovernmental - revenue sharing	1,305.1	1,451.4	-	-	1,305.1	1,451.4
Interest on long-term debt	247.0	281.4	-	-	247.0	281.4
Liquor Purchase Revolving Fund	-	-	544.7	515.2	544.7	515.2
State Lottery Fund	-	-	1,391.4	1,152.8	1,391.4	1,152.8
Attorney Discipline System	-	-	4.1	-	4.1	-
Michigan Unemployment Compensation Funds	-	-	2,349.4	2,473.8	2,349.4	2,473.8
Total expenses	38,969.1	38,716.4	4,289.5	4,141.8	43,258.6	42,858.2
Excess (deficiency) Before Contributions and Transfers	(1,370.0)	(2,015.3)	301.1	45.5	(1,068.9)	(1,969.8)
Contributions to permanent fund principal	30.8	31.9	-	-	30.8	31.9
Transfers	901.6	843.8	(901.6)	(843.8)	-	-
Increase (decrease) in net assets	(437.7)	(1,139.6)	(600.5)	(798.2)	(1,038.2)	(1,937.8)
Net assets – beginning restated	16,433.3	17,572.9	1,771.5	2,569.8	18,204.8	20,142.6
Net assets – ending	\$15,995.6	\$16,433.3	\$1,171.0	\$1,771.5	\$17,166.6	\$18,204.8

Governmental Activities:

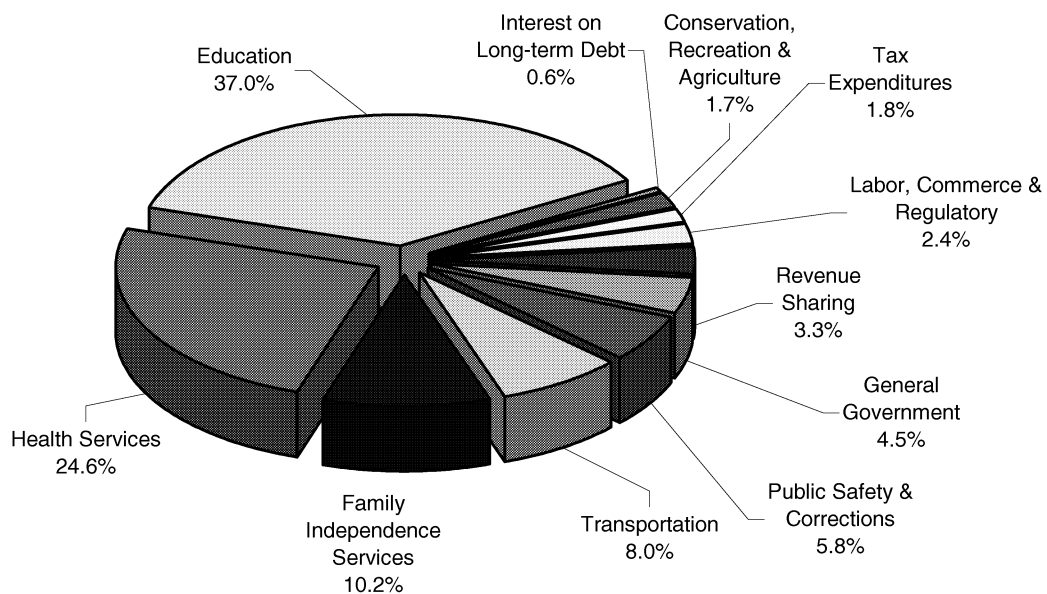
The following chart depicts revenues of the governmental activities for the fiscal year:

**Revenues - Governmental Activities for
Fiscal Year Ending September 30, 2004**
(\$37.6 billion)



The following chart depicts expenses of the governmental activities for the fiscal year:

**Expenses - Governmental Activities for
Fiscal Year Ending September 30, 2004**
(\$39.0 billion)



Business-type Activities

The business-type activities' net assets decreased by \$600.5 million (33.9 percent) during the fiscal year. Factors contributing to these results included:

- The increase in unemployment in the State resulted in the Michigan Unemployment Compensation Funds finishing the fiscal year with a decrease in net assets of \$573.1 million (34.5 percent) to \$1.1 billion.
- The State Lottery Fund's net assets decreased by \$28.1 million (26.7 percent), which resulted from a decrease in the market value of investments that Lottery holds to fund future payments due for lottery prizes.

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

As the State completed the year, its governmental funds reported fund balances of \$3.3 billion. Of this total amount, \$495.5 million constitutes unreserved fund balance, which is available for appropriation for the general purposes of the funds. The Budget Stabilization Fund (\$81.3 million) and the transportation-related funds (\$337.1 million) comprise a significant portion of the unreserved fund balance. The remainder of fund balance is reserved and is not available for new spending because it has already been dedicated for various commitments, such as capital outlay projects.

General Fund

The General Fund is the chief operating fund of the State. At the end of fiscal year 2003-2004, the General Fund unreserved fund balance was transferred to the Budget Stabilization Fund and reserved fund balance was \$1.2 billion. Total fund balance diminished during the fiscal year by \$140.9 million (10.8 percent), primarily because transfers to other funds increased by \$120.8 million.

General Fund Budgetary Highlights:

During fiscal year 2004, the State was again faced with difficult budget challenges resulting in significant expenditure reductions. In December 2003, Executive Order 2003-23 was issued authorizing expenditure reductions of \$200.9 million and transfers of unexpended balances and excess revenues from restricted revenue sources totaling \$147.9 million to be used as general fund, general purpose revenues. In addition, the executive order reduced work project and capital outlay project carry-forward authorization from prior years by \$31.0 million.

In addition to the executive order spending reductions, the original budget was amended by various supplemental appropriations and appropriation reductions. The following summarizes the differences between the original and final budget amounts:

- General purpose tax revenues of \$7.9 billion were \$101.4 million less than the original estimate of \$8.0 billion.
- Restricted revenue inflows of \$13.6 billion were \$312.9 million more than the estimated \$13.3 billion.
- The Merit Award Trust Fund made transfers to the General Fund totaling \$63.0 million as part of the Executive Order 2003-23.
- The General Fund transferred \$81.3 million to the Budget Stabilization Fund at the end of the year.

Differences between the final budget and actual spending result from spending authority lapses of \$122.7 million and restricted revenue authorized but not spent of \$8.9 million.

The Department of Community Health finished the year with a net overexpenditure of \$38.2 million and the Family Independence Agency had line-item overexpenditures of \$1.1 million. All other agencies finished the year with lapses.

In December 2004, the consensus revenue agreement indicated that the General Fund revenues are expected to decline in the next fiscal year. Another consensus revenue conference will be held in January 2005. Corresponding reductions in spending and other measures will help ensure that the fund balance remains positive if revenues decline as expected.

School Aid Fund

Fund balance at September 30, 2004, totaled \$74.1 million, a decrease of \$41.1 million (35.7 percent) from the prior year. Revenues and transfers to the fund totaled \$12.3 billion. Expenditures to school districts and other costs decreased by \$43.5 million from the previous year and totaled \$12.3 billion. During the year, the School Aid budget was adjusted by prorating school aid payments. The school aid payments were reduced by \$131.1 million.

Counter-cyclical Budget and Economic Stabilization Fund

Fund balance increased by \$81.3 from the previous year as a result of the transfer from the General Fund.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets: At the end of the fiscal year 2003-2004, the State had invested \$18.7 billion, net of accumulated depreciation, in a broad range of capital assets (see the table below). Depreciation charges for this fiscal year totaled \$182.6 million.

Capital Assets as of September 30
(Net of Depreciation, In Millions)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2004	2003	2004	2003	2004	2003
Land	\$ 3,117.0	\$ 3,103.1	\$ -	\$ -	\$ 3,117.0	\$ 3,103.1
Land improvement	86.5	75.7	-	-	86.5	75.7
Buildings and improvements	2,047.4	2,088.2	-	-	2,047.4	2,088.2
Equipment	144.5	163.9	.6	.6	145.0	164.4
Infrastructure	11,964.6	11,831.3	-	-	11,964.6	11,831.3
Other	19.8	18.9	-	-	19.8	18.9
Subtotal	17,379.8	17,281.0	.6	.6	17,380.4	17,281.6
Construction in progress	1,315.0	1,388.0	-	-	1,315.0	1,388.0
Total	\$18,694.8	\$18,669.0	\$.6	\$.6	\$18,695.4	\$18,669.6

The most significant impact on capital assets during the year resulted from the road and bridge construction and repair projects.

As allowed by GASB Statement No. 34, the State has adopted an alternative process for recording depreciation expense on selected infrastructure assets. Under this alternative method, referred to as the modified approach, the State expenses certain maintenance and preservation costs and does not report depreciation expense. Assets accounted for under the modified approach include the State's network of public transportation roads and bridges, including ancillary assets, such as guard rails, signs, lighting, culverts, fencing, and the like. The State is responsible for maintaining approximately 27,534 lane miles of roads and 4,724 bridges (spans in excess of 20 feet).

The State has consistently improved the assessed condition of roads over the past five years. The State's goal is to have no more than 30% of roads in "poor" or "very poor" condition. The most recent condition assessment, completed for calendar year 2003, indicated that 20.0% of roads were considered poor or very poor.

The State's bridges have assessed conditions that are better than the established benchmarks. The most recent assessment (2003) indicated that the condition of the bridges had improved from the condition reported for 2002.

The State's fiscal year 2004-2005 capital outlay appropriations have not been enacted except for the rent payments made to the State Building Authority totaling \$250.8 million. Unspent capital outlay authorizations of \$463.0 million that existed at September 30, 2004, are available in fiscal year 2005. More detailed information about the State's capital assets is presented in Note 9 to the financial statements.

Long-term Debt: The State, along with the State Building Authority (SBA), a blended component unit of the State, are empowered by law to authorize, issue, and sell debt obligations. General obligation bonds, issued by the State, are backed by the full faith and credit of the State. The State also issues revenue dedicated bonded debt, whose payment for principal and interest comes solely out of funds that receive legally restricted revenues. The State is not legally obligated for the debt issued by SBA. SBA's bonds generate revenue to finance the construction of facilities used by the State and universities. Revenues derived from leases on the facilities fund the debt service requirements. More detailed information regarding the State's long-term obligations is presented in Notes 12 and 14 to the financial statements.

Outstanding Bonded Debt as of September 30
(In Millions)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2004	2003	2004	2003	2004	2003
General obligation bonds (backed by the State)	\$1,527.5	\$1,413.4	\$ -	\$ -	\$1,527.5	\$1,413.4
Revenue bonds and notes (backed by specific tax and fee revenues)	3,987.7	3,919.6	-	-	3,987.7	3,919.6
Total	\$5,515.2	\$5,333.0	\$ -	\$ -	\$5,515.2	\$5,333.0

During fiscal year 2003-2004 the State issued general obligation debt totaling \$302.8 million, including \$64.5 million for conservation and recreation projects (the Clean Michigan Initiative) and \$238.3 million to provide funds for loans to school districts.

Bond Ratings

The State's general obligations are rated AA+ by Standard & Poors and Aa1 by Moody's.

Limitations on Debt

The State Constitution authorizes general obligation long-term borrowing, with approval of the Legislature and a majority of the voters, and general obligation short-term notes, of which the principal may not exceed 15% of undedicated revenues received in the preceding year. In fiscal year 2003-2004 the State issued and repaid short-term borrowing totaling \$1.3 billion.

ECONOMIC CONDITION AND OUTLOOK

Michigan's economy relies heavily on the performance of the manufacturing sector in general and the auto industry specifically. Given extremely weak manufacturing employment performance, declining vehicle production, continued declines in Big 3 market share along with continued supply rationalization among vehicle suppliers, Michigan's employment performance has been below the national average. Substantial productivity gains in the manufacturing sector and vehicle industry have also contributed to Michigan's sub-par employment performance.

Through October, state employment is down compared to a year ago. From Michigan's employment peak in June 2000 compared to October 2004, Michigan has lost more than 300,000 jobs. By this time after the 1990-1991 recession, Michigan employment had risen nearly 200,000 jobs above its pre-recession peak. Michigan manufacturing employment has declined even more sharply. Since June 2000, Michigan manufacturing employment has fallen by slightly more than 200,000 jobs.

However, with continued U.S. economic growth, smaller declines in manufacturing sector employment and improvements in the private non-manufacturing sector, Michigan employment is expected to grow each quarter, with employment gains averaging a modest 8,000 jobs per quarter. For 2004, employment is estimated to have declined by 49,000 jobs (1.1 percent) – the fourth straight annual Michigan employment decline. With slight growth in 2005, employment is forecast to average 0.3 percent higher than 2004 employment. After falling from 7.3 percent to 6.7 percent in 2004, Michigan's unemployment rate is forecast to rise to 6.9 percent in 2005.

Michigan personal income is projected to rise 4.5 percent in 2005, after increasing an estimated 2.7 percent in 2004. In 2005, wages and salaries income is forecast to grow 3.7 percent after rising slightly (0.7 percent) in 2004. As measured by the Detroit CPI, consumer prices are projected to increase 2.4 percent.

CONTACTING THE STATE'S OFFICE OF FINANCIAL MANAGEMENT

This financial report is designed to provide our citizens, taxpayers, customers, investors, and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. Additional copies of this report and other financial information can be obtained by visiting the Office of Financial Management website at www.michigan.gov/ofm. You can also contact the office by phone at (517) 373-3029.

The State's component units issue their own separately issued audited financial statements. These statements may be obtained by directly contacting the component unit. To obtain their phone numbers, you may contact the Office of Financial Management at (517) 373-3029.